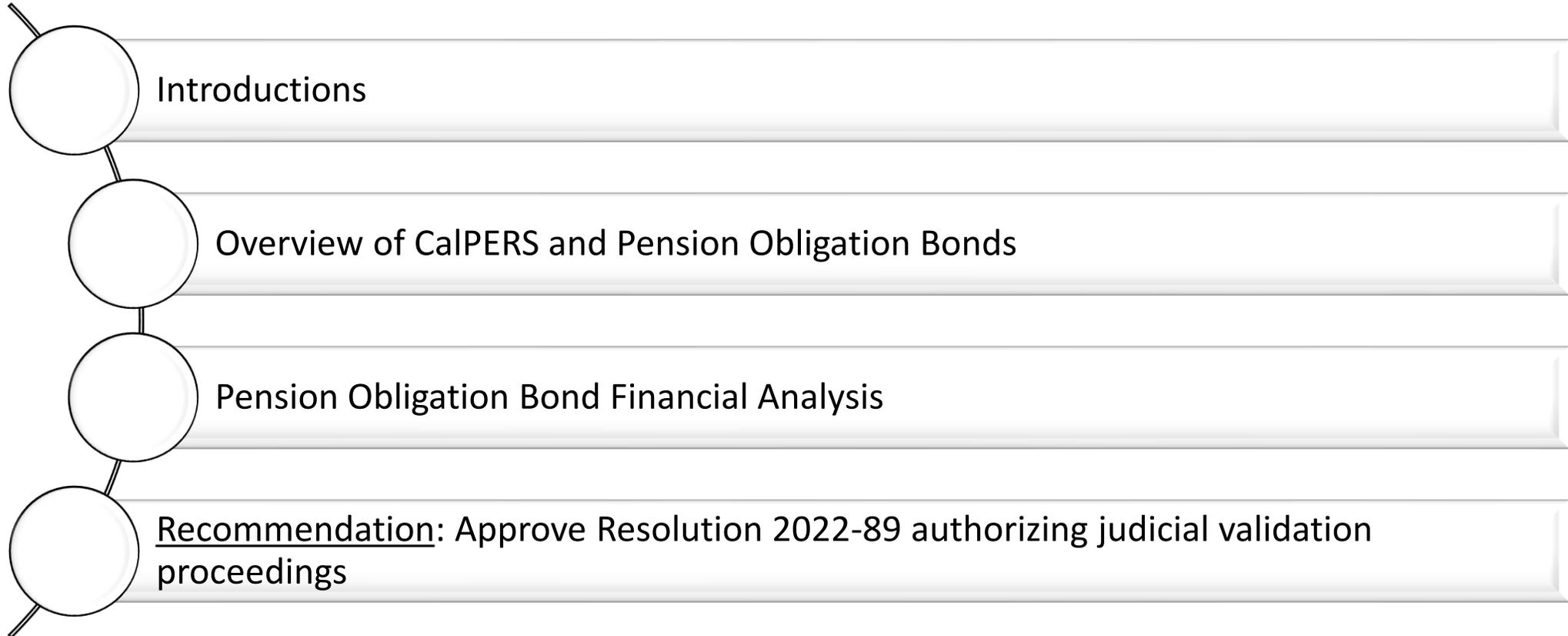


# City of Escondido

## Approval to Commence Judicial Validation Proceedings for Pension Obligation Bonds

June 22, 2022

# Overview of Presentation



# Introductions – Bond Financing Team

**Sara Brown**, Managing Director of Stifel Public Finance, Bond Underwriter

**Scott Smith**, Principal of CSG Advisors, Municipal Financial Advisor

## City of Escondido

- 2022 The Villages CFD Bonds
  - 2021 Wastewater Refunding Bonds
  - 2019 Water Refunding Bonds
- 
- Recent POBs for the Cities of Chula Vista, Orange, Huntington Beach, Manhattan Beach and El Segundo

# Overview of CalPERS

Most cities in California, including Escondido, contract with **CalPERS** for their employees' retirement benefits

- CalPERS provides for and manages the City's employee pension plans

Escondido has two Plans with CalPERS:

**Safety Plan** – Sworn Police and Fire Employees

**Miscellaneous Plan** – All Other Employees\*

\*General Fund, Water, Wastewater, Internal Service & Special Revenue Funds

# Overview of CalPERS

Every year, the city and employees contribute to CalPERS to pay for future retirement benefits. The City makes two types of payments to CalPERS:

- **Normal Cost (NC)**

Annual cost for current employees

- **Unfunded Accrued Liability (UAL)**

Actuarial Liability MINUS Actuarial Value of Assets

# Unfunded Accrued Liability Calculation

The UAL is the difference between the City’s retirement plan assets and the amount that will be needed to be paid as a retirement benefit to members

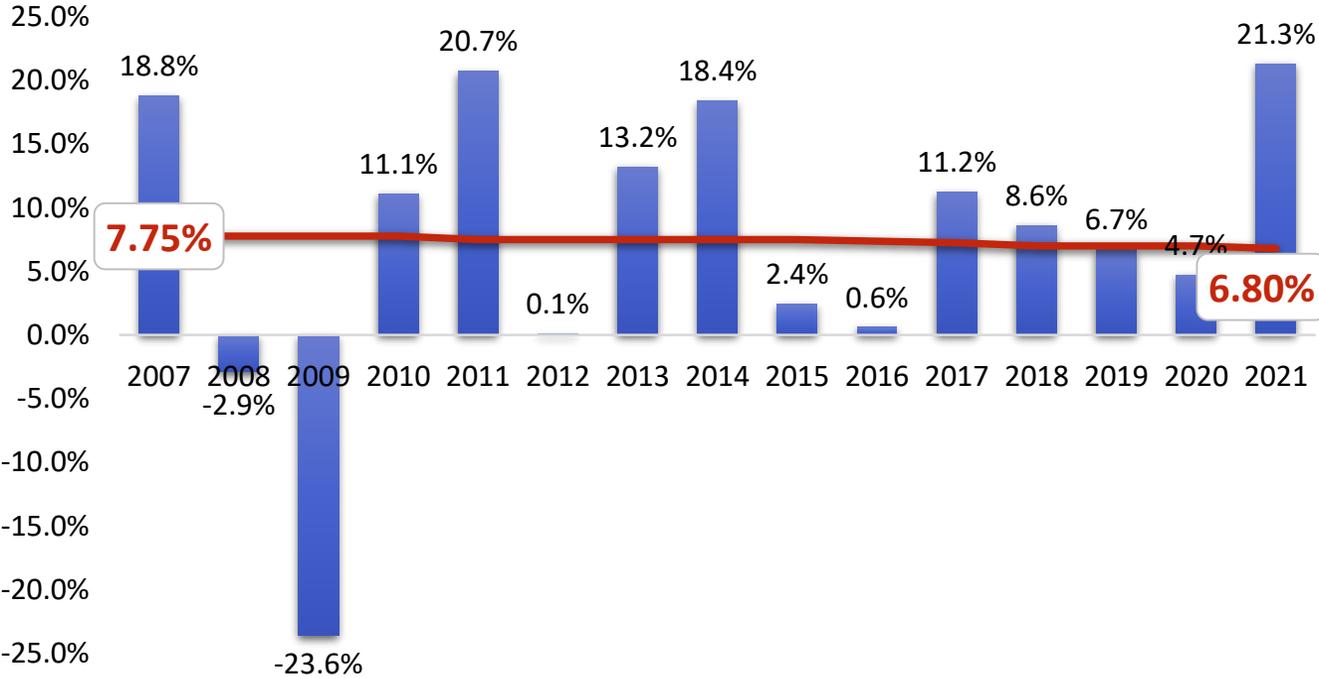
	<u>Safety</u>	<u>Miscellaneous</u>	<u>Total</u>
CalPERS Accrued Liability	\$445,123,581	\$469,434,960	\$914,558,541
Market Value of Assets (MVA)	\$308,125,828	\$317,151,631	\$625,277,459
<b>Unfunded Accrued Liability (UAL)</b>	<b>\$136,997,753</b>	<b>\$152,283,329</b>	<b>\$289,281,082</b>
Funded Ratio	69.2%	67.6%	68.4%

- Safety Plan: Funded by the General Fund
- Miscellaneous Plan: Funded by the General Fund, Water, Wastewater, Internal Service & Special Revenue Funds

# Unfunded Accrued Liability Calculation

*Historically, more than 60% of all funds paid to CalPERS retirees comes from investment earnings.*

**History of CalPERS Investment Returns**



**Discount Rate**  
the estimated long-term average return expected to be earned on investments.

**As a result of reductions in the discount rate, the City is required to contribute more each year.**

# What are Pension Obligation Bonds?

*Taxable form of debt issued by governmental employers to retire all or a portion of their Unfunded Accrued Liability (“UAL”) with the goal of reducing future liability*

<u>Unfunded Accrued Liability</u>	<u>Pension Obligation Bond</u>
<ul style="list-style-type: none"><li>– City owes \$289M to CalPERS</li></ul>	<ul style="list-style-type: none"><li>– City owes \$289M to investors</li></ul>
<ul style="list-style-type: none"><li>– City pays the discount rate, 6.8%</li></ul>	<ul style="list-style-type: none"><li>– City would pay the <b>bond rate</b></li></ul>
<ul style="list-style-type: none"><li>– City pays an adjustable interest rate that can vary in the coming years</li></ul>	<ul style="list-style-type: none"><li>– Bond rate is a fixed interest rate that does not change for the term of the bonds</li></ul>
<ul style="list-style-type: none"><li>– New UAL can be added if CalPERS’ assumptions change or future interest earnings are below the discount rate</li></ul>	<ul style="list-style-type: none"><li>– New UAL can be added if CalPERS’ assumptions change or future interest earnings are below the discount rate</li></ul>
<ul style="list-style-type: none"><li>– Final Payment is 2043</li></ul>	<ul style="list-style-type: none"><li>– <b>City can modify</b> to meet its objectives</li></ul>

**POBs are a tool with certain benefits and risks**

# Pension Obligation Bonds – **Key Benefits**

Fiscal  
Sustainability  
Tool

Budgetary  
Savings

Interest Rate  
“Savings”

Maturity  
Modification

Preservation  
of Reserves &  
Services

# Pension Obligation Bonds – **Key Risks**

**Converts  
Obligation from  
“Variable” Into  
“Fixed”**

**Low Pension Fund  
Interest Returns**

**High Pension Fund  
Interest Returns**

**Future UAL can  
still change**

**Increased Bonded  
Debt**

**Judicial Validation**

**Political Process**

# Why Pension Obligation Bonds?

## **POBs may represent part of a solution to the City's pension liability**

- Historically low interest rates in 2021, especially in relation to the CalPERS discount rate have made POBs more attractive

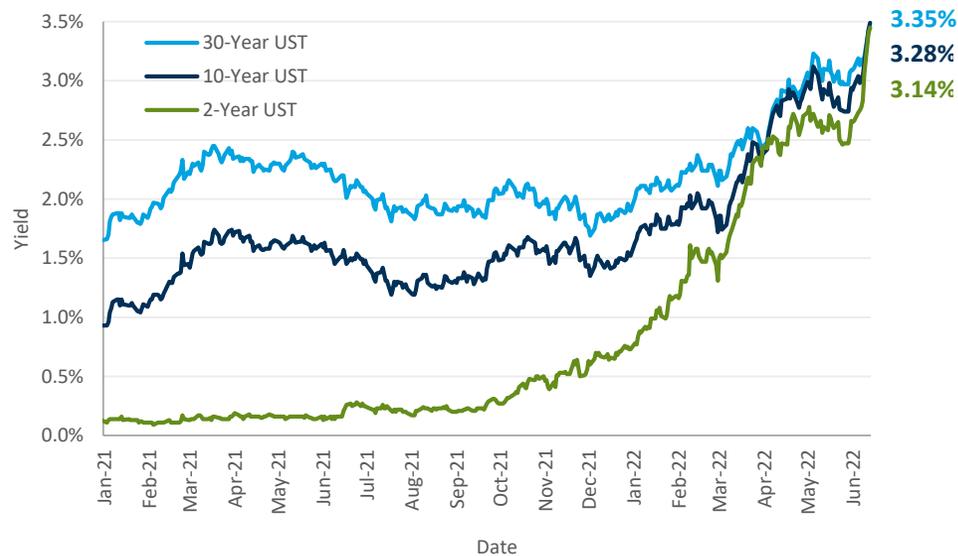
## **Objectives of a POB Issuance**

- Increase financial sustainability
- Achieve savings – dependent on the current interest rate environment

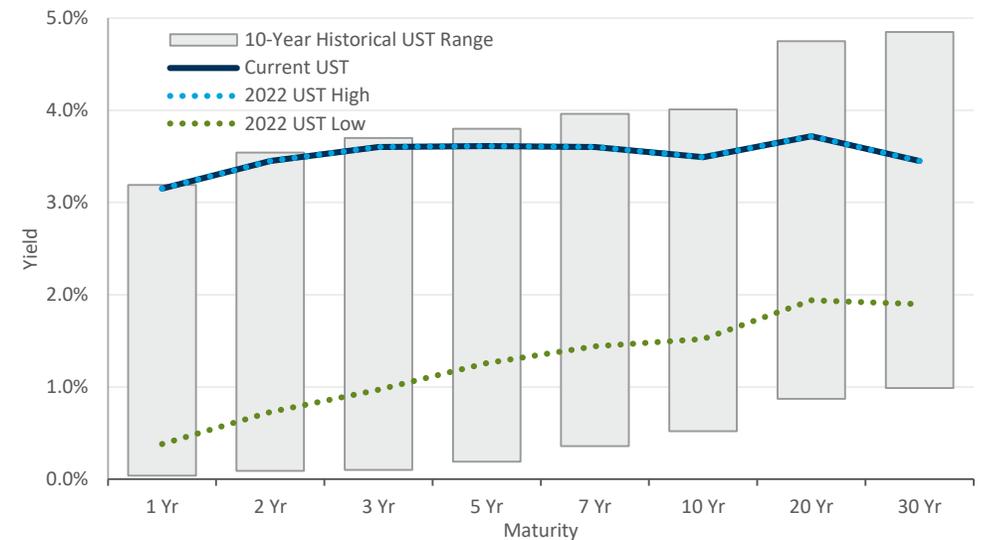
# Taxable Interest Rate Movement

- After a long period of favorable market conditions, 2022 has been marked by volatility and rising interest rates
  - Primary driving forces are inflation and economic uncertainty
  - Federal Reserve has raised Fed Funds rate 150 basis points YTD and is expected to increase another 50-75 basis points in July
- Treasury yield curve has flattened significantly with short term interest rates increasing the most; the 2-year and 30-year Treasuries are nearly at the same level

Comparing 2, 10 and 30-Year UST since January 1, 2021

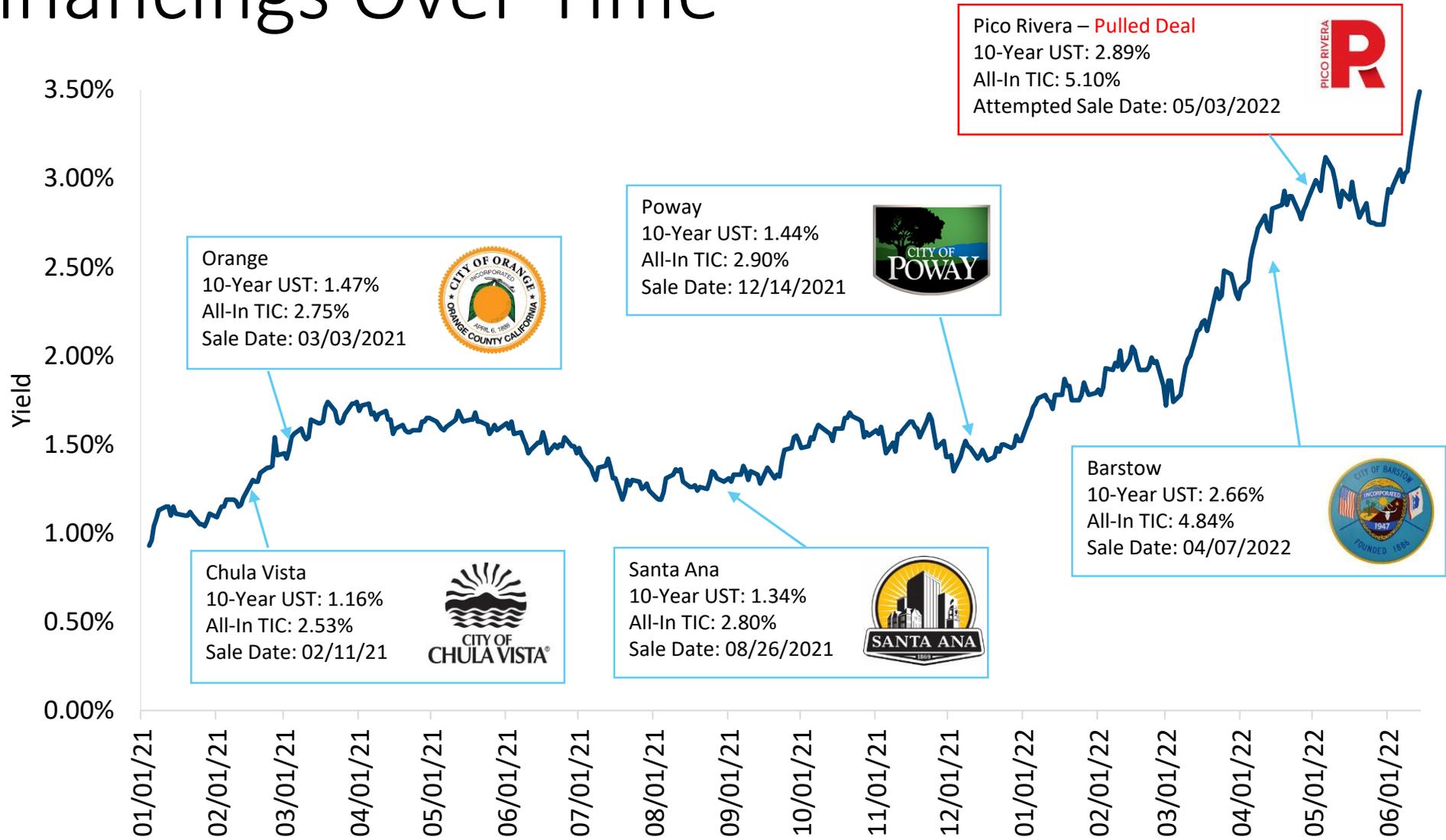


Current US Treasury Yield Curve



Source: TM3, US Treasury. As of 6/16/2022.

# POB Financings Over Time

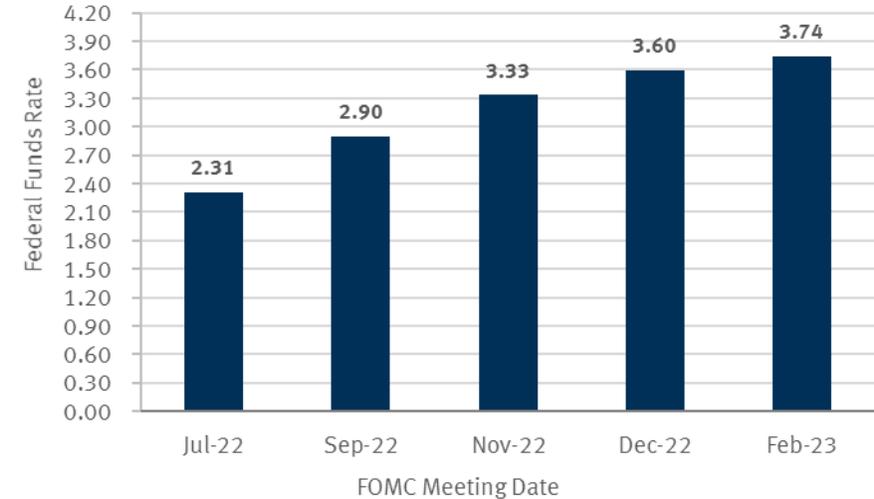


# Interest Rate Forecast

- Last week (6/15), the Fed hiked rates by 75 basis points. Going forward, the market continues to anticipate a second-round 75bps increase at the July FOMC meeting.
- According to the latest Summary of Economic Projections (SEP), the Fed remains convinced that a “softish” landing is still achievable. While lowering the 2022 and 2023 growth outlook, the Committee maintains an expectation of positive growth.

Market Consensus Yield Curve Projections (%)					
	Current	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Fed Funds	1.75	1.75	2.90	3.45	3.70
2-Yr UST	3.18	3.00	3.00	3.08	3.14
10-Yr UST	3.27	3.17	3.13	3.14	3.20
30-Yr UST	3.29	3.24	3.27	3.30	3.35

Market Implied Fed Funds Effective Rate After Each Fed Meeting

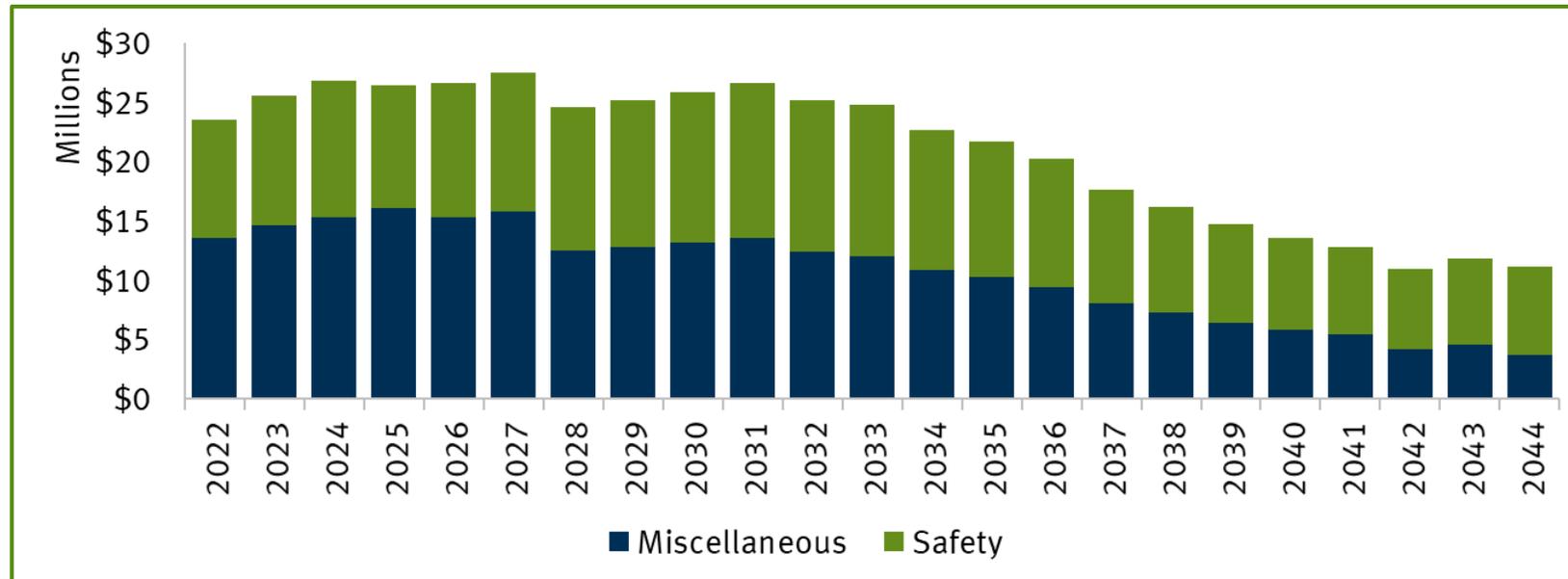


Source: Stifel Fixed Income Strategy Department, U.S. Treasury Department, Bloomberg, Reuters as of 6/17/2022

# Funded Status Overview

City of Escondido UAL Calculation Based on CalPERS 6/30/2020 Valuation					
			Miscellaneous	Safety	Total
A	Present Value of Projected Benefits		\$521,711,939	\$521,447,420	\$1,043,159,359
B	Entry Age Normal Accrued Liability		\$469,434,960	\$445,123,581	\$914,558,541
C	Market Value of Assets (MVA)		\$317,151,631	\$308,125,828	\$625,277,459
D	<b>Unfunded Accrued Liability (UAL)</b>	<b>B - C</b>	<b>\$152,283,329</b>	<b>\$136,997,753</b>	<b>\$289,281,082</b>
E	<b>Funded Ratio</b>	<b>C / B</b>	<b>67.6%</b>	<b>70.3%</b>	<b>69.2%</b>

## Projected Combined UAL Payments



# CalPERS Changes to UAL for FY 2021

**CalPERS' investment earnings in FY 2021 were significantly higher than the discount rate, leading to a credit to the City's UAL**

- CalPERS achieved an approximately 21.3% return in FY2021, outperforming the targeted (at the time) 7.0%
- The strong performance increased the City's total market value of assets, providing a credit of approximately \$88.2 million to the City's UAL

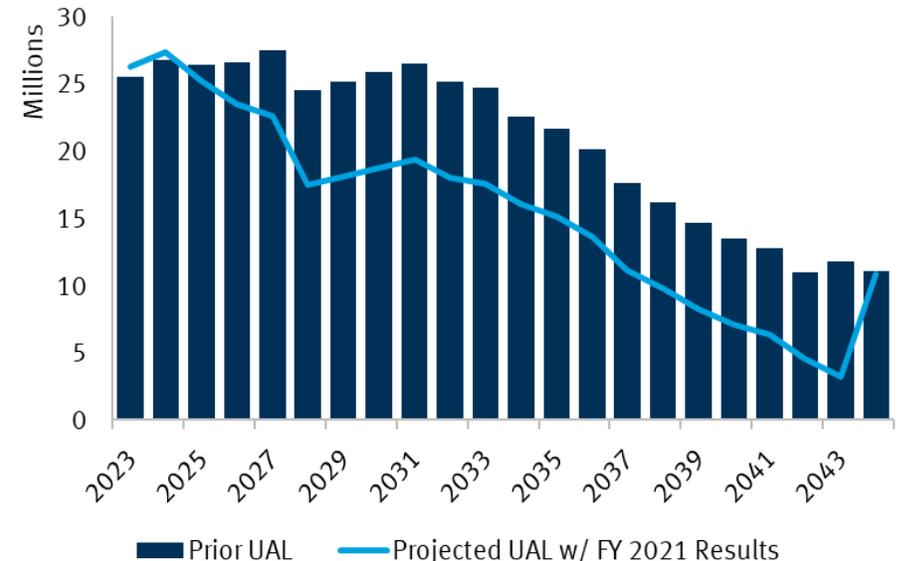
**Due to the strong performance, CalPERS took the opportunity to review their actuarial assumptions and lower the discount rate**

- CalPERS lowered the discount rate from 7.0% to 6.8%, increasing the City's accrued liability, resulting in a new liability of approximately \$24.0 million
- The change also causes the City's current bases to be amortized at the lower rate (increasing payments)

**Net-net, the City's unfunded accrued liability experienced a net credit of approximately \$64.1 million**

Projected Changes to City's UAL	
UAL per the 6/30/20 Report	\$289,281,082
City UAL Pay Down in FY21 and FY22	(5,517,590)
Credit from Investment Outperformance	(88,164,122)
Liability from Discount Rate Change	24,016,401
<b>Projected UAL Balance w/ FY 2021 Results</b>	<b>\$219,615,771</b>

**Estimated UAL Payment Schedule**



# CalPERS Changes to UAL for FY 2022

- **CalPERS is not expected to meet its investment target of 6.8% in FY 2022**
  - S&P 500 Index return since 6/30/21 is about -4.5%; CalPERS is weighted toward the same large cap equities
- **Assuming CalPERS earns -4.5% in FY 2022, the City would add an additional liability of \$83.4 million**
  - The additional bases results in an additional \$9.4 million in payments annually after the ramp-up

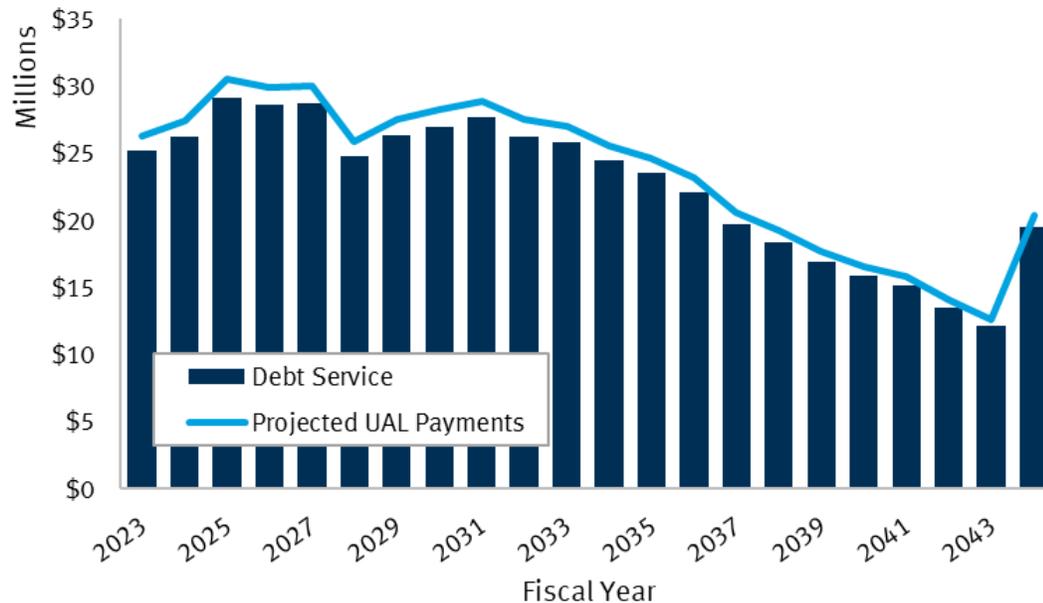


# Hypothetical POB

## Proportional Scenario

- Analysis assumes a refinancing of 100% of projected FY 2022 UAL, including the market loss in FY 2022
- \$22.5 million in cash flow savings over the life of the issue
  - True Interest Cost (TIC): 5.63%
  - Estimated NPV savings of 4.6%

Estimated POB Payments vs Current Projected UAL Schedule



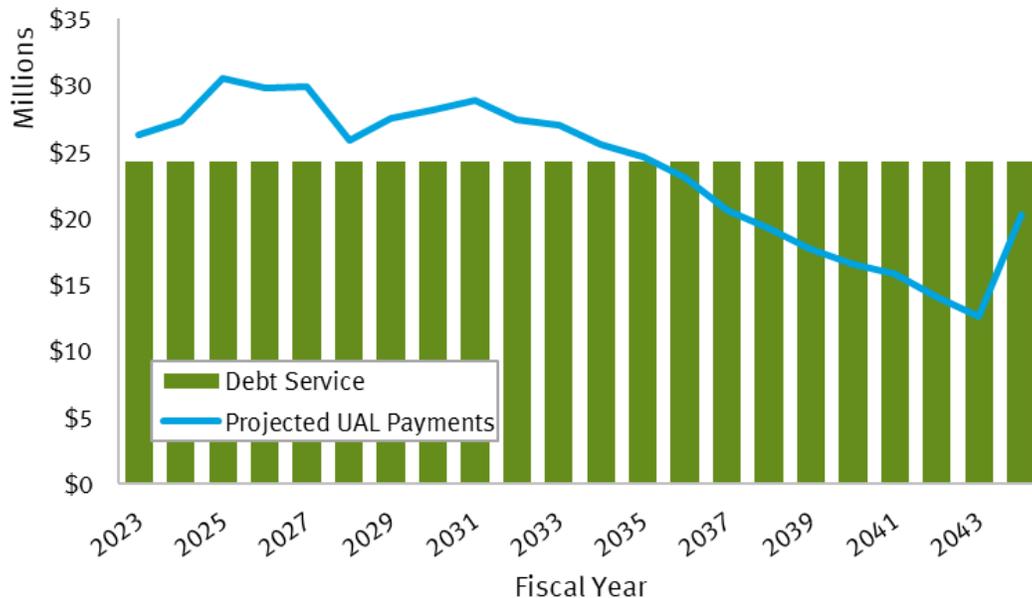
Fiscal Year	CalPERS Payment	2022 POBs	
		Debt Service	Savings
2023	\$26,282,019	\$25,141,352	\$1,140,667
2024	27,358,089	26,171,005	1,187,084
2025	30,480,530	29,156,708	1,323,823
2026	29,838,531	28,545,768	1,292,763
2027	29,955,367	28,657,612	1,297,755
2028	25,855,005	24,731,224	1,123,782
2029	27,534,398	26,336,924	1,197,475
2030	28,189,395	26,964,854	1,224,541
2031	28,862,404	27,609,508	1,252,896
2032	27,454,045	26,260,388	1,193,658
2033	27,011,008	25,836,401	1,174,607
2034	25,524,177	24,415,648	1,108,529
2035	24,579,016	23,510,450	1,068,566
2036	23,111,883	22,110,705	1,001,178
2037	20,595,957	19,699,485	896,472
2038	19,182,005	18,348,675	833,330
2039	17,677,521	16,911,740	765,781
2040	16,522,907	15,804,000	718,907
2041	15,813,608	15,128,490	685,118
2042	14,027,880	13,421,225	606,655
2043	12,634,458	12,087,460	546,998
2044	<u>20,307,864</u>	<u>19,428,768</u>	<u>879,097</u>
	<b>\$518,798,067</b>	<b>\$496,278,385</b>	<b>\$22,519,682</b>

# Hypothetical POB

## Level Scenario

- Analysis assumes a refinancing of 100% of projected FY 2022 UAL, including the market loss in FY 2022
- About \$23 million in cash flow savings in first 5 years but negative savings overall
  - True Interest Cost (TIC): 5.72%
  - Estimated NPV savings of 3.8%

### Estimated POB Payments vs Current Projected UAL Schedule



Fiscal Year	CalPERS Payment	2022 POBs	
		Debt Service	Savings
2023	\$26,282,019	\$24,211,740	\$2,070,279
2024	27,358,089	24,215,166	3,142,923
2025	30,480,530	24,211,506	6,269,024
2026	29,838,531	24,213,226	5,625,305
2027	29,955,367	24,214,682	5,740,685
2028	25,855,005	24,214,618	1,640,387
2029	27,534,398	24,215,656	3,318,743
2030	28,189,395	24,213,106	3,976,289
2031	28,862,404	24,215,322	4,647,082
2032	27,454,045	24,213,420	3,240,626
2033	27,011,008	24,214,441	2,796,567
2034	25,524,177	24,213,622	1,310,555
2035	24,579,016	24,216,268	362,748
2036	23,111,883	24,213,740	(1,101,857)
2037	20,595,957	24,211,648	(3,615,691)
2038	19,182,005	24,214,858	(5,032,852)
2039	17,677,521	24,213,355	(6,535,834)
2040	16,522,907	24,216,278	(7,693,371)
2041	15,813,608	24,215,115	(8,401,507)
2042	14,027,880	24,211,650	(10,183,770)
2043	12,634,458	24,212,373	(11,577,914)
2044	<u>20,307,864</u>	<u>24,213,188</u>	<u>(3,905,323)</u>
<b>Total</b>	<b>\$518,798,067</b>	<b>\$532,704,972</b>	<b>(\$13,906,904)</b>

Fiscal Year	CalPERS Payment	POB Savings			
		Current Market	-50	-100	-150
2023	\$26,282,019	\$1,140,667	\$2,098,718	\$3,042,300	\$3,966,746
2024	27,358,089	1,187,084	2,185,009	3,167,651	4,130,368
2025	30,480,530	1,323,823	2,432,307	3,526,082	4,605,412
2026	29,838,531	1,292,763	2,380,278	3,454,973	4,506,962
2027	29,955,367	1,297,755	2,393,431	3,468,365	4,522,902
2028	25,855,005	1,123,782	2,066,744	2,991,891	3,904,418
2029	27,534,398	1,197,475	2,198,345	3,188,247	4,157,128
2030	28,189,395	1,224,541	2,253,371	3,263,678	4,255,845
2031	28,862,404	1,252,896	2,304,236	3,340,553	4,357,230
2032	27,454,045	1,193,658	2,191,342	3,178,191	4,144,849
2033	27,011,008	1,174,607	2,154,960	3,123,694	4,076,988
2034	25,524,177	1,108,529	2,036,509	2,952,672	3,853,544
2035	24,579,016	1,068,566	1,965,244	2,845,191	3,710,290
2036	23,111,883	1,001,178	1,843,979	2,675,862	3,488,785
2037	20,595,957	896,472	1,646,189	2,380,854	3,113,009
2038	19,182,005	833,330	1,532,998	2,218,615	2,897,358
2039	17,677,521	765,781	1,411,874	2,045,174	2,667,714
2040	16,522,907	718,907	1,318,704	1,912,167	2,496,402
2041	15,813,608	685,118	1,264,183	1,828,378	2,390,178
2042	14,027,880	606,655	1,122,163	1,620,250	2,117,958
2043	12,634,458	546,998	1,008,413	1,460,201	1,908,673
2044	<u>20,307,864</u>	<u>879,097</u>	<u>1,624,042</u>	<u>2,347,059</u>	<u>3,069,244</u>
	<b>\$518,798,067</b>	<b>\$22,519,682</b>	<b>\$41,433,039</b>	<b>\$60,032,047</b>	<b>\$78,342,003</b>

NPV Savings (\$)	\$13,817,279	\$26,424,286	\$39,844,628	\$54,148,504
NPV Savings (% of UAL)	4.56%	8.72%	13.15%	17.87%
True Interest Cost	5.63%	5.13%	4.63%	4.12%

# Interest Rate Sensitivity

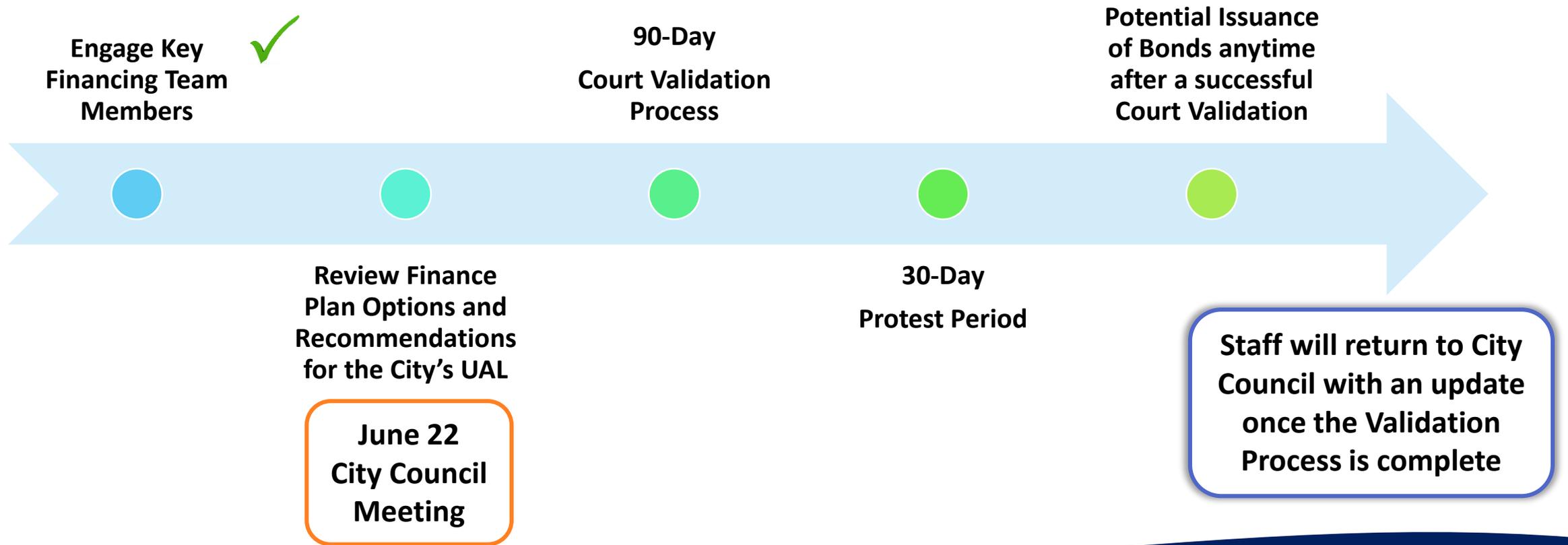
## Sensitivity Analysis: How do market movements impact savings?

- The hypothetical analysis to the left shows savings achieved from POB payments vs the projected UAL payment schedule under different interest rate assumptions
  - Analysis assumes a refinancing of 100% of projected FY 2022 UAL, including the market loss in FY 2022
  - Proportional debt service scenario
- NPV Savings range from 4.56% to 17.87%

# Next Steps - Court Validation Process

- POBs fall under an exception to the constitutional debt limit because of a public agency's obligation to fund its pension system payments.
- POB documents are “validated” in Superior Court
  - **Validation does not obligate the City to issue bonds, nor even to have agreed on a specific plan of finance.**
- First step in the validation process is the preparation of bond documents.
  - **The documents have been prepared with maximum flexibility regarding bond structure and terms to position the City to move quickly if it decides to issue POBs at a future date.**

# Timeline for the Issuance of POBs



# Recommendations

- Approve Resolution No. 2022-89 authorizing judicial validation proceedings relating to the issuance of bonds to refund certain pension obligations of the City, approving the form and authorizing the execution of a trust agreement and bond purchase agreement